

THE ECONOMIC SITUATION

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A quarterly report on economic trends.

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How sweet it is! Or was. Can the economy stay the course?
Inflation? Is there something there?
Mr. Greenspan's challenge? Can he cool financial markets without freezing them?
The South Carolina economy. Where are retail sales hottest?
Who owns the Great American Bread Machine?

Can the Economy Maintain this Pace?

In February, the U.S. Department of Commerce announced that fourth quarter 1999 GDP had accelerated at the unbelievable rate of 6.9%. That was 1.1 percentage points more than the estimate provided just a few weeks earlier.

Impossible! The U.S. economy just can't operate at such a pace.

One month later, Commerce provided an adjustment to the data. Guess what? The latest figure says the fourth quarter economy was perking at 7.3%.

Can the U.S. economy operate at such a pace without blowing its top? A quick glance at history says we may be setting some near records. Back in 1984, the economy generated GDP at a 7.4% rate for the year. To beat that, we must go back to 1951 when the post-war economy was churning at 7.6%. Just before that, the 8.7% pace for 1950 was even hotter. But that's about it, folks. Let's not bet the farm on the current pace being sustained.

The Blue Chip forecasters seem to agree. Their consensus forecast for 2000 calls for GDP growth of 4.1%. They see a 3.1% growth for 2001. But are the forecasters attempting to predict what the economy might do, or what Mr. Greenspan might do to slow the economy? To

ECONOMIC PERFORMANCE BY DECADE

	1960s	1970s	1980s	1990s
Real GDP Growth	4.4%	3.3%	3.1%	3.1%
Unemployment Rate	4.8	6.2	7.3	5.8
CPI Inflation Rate	2.3	7.1	5.6	3.0
S&P Real Total Returns	6.6	-0.5	12.9	15.9

Note: Data are from the Federal Reserve Bank of St. Louis and are annual rates of change calculated using quarterly data.

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predict one, they must predict the other.

The Inflation-Fear Jitters

The pace of economic activity is enough to give Mr. Greenspan the inflation-fear jitters. And that's enough to make the rest of us nervous. Time and again, he has warned Congress and lesser assemblies that the Fed will make preemptive strikes in an attempt to eliminate any fuel that might stoke inflation's ugly fires. We have witnessed five successive increases in Fed-controlled interest rates in the last year. Meanwhile, life continues.

What about inflation? Is there something to fear?

Consider the record as shown by the all-items CPI. Over the last five years, the CPI has risen at a compounded rate of 2.3%. The 1999 average increase was 2.7%. The increase for the 12 months ending in February 2000 was 3.2%. By this measure, the inflation pace is picking up.

But let's consider the same data when the volatile food and energy prices are removed. Is the picture any better?

The adjusted CPI has risen at an annual rate of 1.2% over the last five years. The 1999 average increase was 1.9%, and the increase for 12 months ending in February 2000 was 2.1%. When considered on a relative basis, the adjusted CPI looks worse than the all-item CPI.

Can we find comfort by examining the GDP inflation index? And what about the National Association of Purchasing Managers' Index? For 1998, GDP measured inflation rose 0.7%. For 1999, the increase was 1.5%, with fourth quarter 1999 showing an increase of 2.3%. The NAPM prices paid index stood at 54.7 in July, 1999. In February it was 74.1.

Yes, by these measures, there is clearly some inflation out there.

What about Interest Rates?

Inflation tends to get captured in the interest charged by rational people who lend us their money. They want a

return of purchasing power plus a bit more. All else equal, interest rates rise with expected inflation, especially as seen in the 30-year bond. I generally focus on the 10-year Treasury note, since there are some strange anomalies seen in the path followed by the 30-year bond.

Since January 1998, the yield on the 10-year note has increased practically in lock-step with increases in the Producer Price Index. Can we detect any effect of the Fed's run up in short-term interest rates? Yes. The rate of increase in the PPI is falling, as is the yield on the 10-year bond.

Given the tea leaves in the cup, the interest rate forecast calls for a fractional decline in the 10-year bond interest rate. We should see a range of 6.10% to 6.20% in the next quarter. Incidentally, the 10-year bond, which was yielding 5.20% in March 1999, was pumping at 6.28% in mid-March this year, which is pretty much what was predicted in the last Economic Situation Report. The Blue-Chip forecasters call for an average of 6.5% for 2000. I think the average will be lower than that.

The Fed Challenge

Buoyed by the frothy performance of the stock market, the nation's consumers have continued to increase spending at a faster clip than the growth rate of total personal income, at least until just recently. Apparently, the credit cards were wearing thin. Just as the stock market began to swoon a tad, consumers started cutting back on spending a bit. Interesting how it all works out, isn't it?

Mr. Greenspan and his colleagues face a daunting challenge. If they choose to use the crude tools available to them for steering this powerful economy, they will have to keep tightening the money supply till something gives. Mr. Greenspan indicates that the stock market is the something. He apparently hopes that taking the edge off the market will slow consumer spending as well. And that's a pretty safe bet.

There is no doubt that higher interest rates reduce the present value of projected corporate earnings, and therefore the prices people pay for shares. Higher interest rates also raise the cost of debt and shorten lines in front

of the loan officers' desks. But will the effect be the same for the so-called New and Old Economy firms? Can Mr. Greenspan reduce stock market enthusiasm without crippling old economy stocks?

The answer is yes. But new economy firms typically hold larger amounts of cash and less debt than old economy firms. And new economy firm earnings are far more speculative. Higher interest rates may actually give the new guys a positive nudge, while the older ones are staggering. At some point, however, investors accept the central bank's threat. The high flyers will be taken down a bit and the old economy stocks will look a bit more attractive.

The South Carolina Economy

South Carolina entered the new year with a strong but slowing economy. The current 2.5% employment growth rate is stronger than the nation's and one of the stronger in the region. But 2.5% is pale when compared with the 3.88% registered in 1998. Put another way, the state's economy is sailing along at a comfortable pace, but there is not nearly as much wind rushing through the sails.

Weaknesses are observed primarily in manufacturing and construction employment. International competition continues to take a toll on the state's textile and apparel sector, and higher interest rates seem to be

affecting the housing sector. With this said, there are still sound expectations that the year 2000 will provide a solid record of economic growth.

An examination of 1999 retail sales by county provides some interesting data. Ranked on the basis of total retail sales, the top 10 counties are: Greenville, Charleston, Richland, Spartanburg, Horry, Lexington, Florence, Anderson, York, and Beaufort. This looks a lot like the path of the interstate highways. But when ranked on the basis of 1997-99 growth in retail sales, the top 10 counties are: Chesterfield, Barnwell, Union, York, Calhoun, Anderson, Greenwood, Berkeley, Beaufort, and Jasper.

Just two counties—Anderson and Beaufort—appear on both lists. They are the state's retail hot spots.

What's Wonderful about America

We have much to celebrate. Our relatively free, free-market economy continues to provide an amazing amount of goods and services that can be enjoyed by the American people. Out of this horn of plenty comes the richest variety of goods ever witnessed in markets. But we are investors as well as consumers. Rank and file Americans own the Great American Bread Machine. What percent of families own shares in America? What about the poor? The data in this last chart speak for themselves.

STOCK OWNERSHIP BY INCOME BRACKET 1989-95

Family Income	1989	1995	Increase
< \$10,000	3%	6%	+88%
10,000-24,999	13	23	79
25,000-49,999	32	47	46
50,000-99,999	52	67	28
100,000 & more	82	81	00

Source: Cato Institute, 11/1999. Original data, Board of Governors, Federal Reserve, 1/1997.

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